Financial Standardization in Comparative Perspective: the Cases of Malaysia and South Korea

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Abstract

After the 1997 crisis in East Asia the IMF began to promote international financial standards in the region. The IMF believed that the implementation of such good practices can secure sustainable growth for the countries of the region. Since then economics followed with curiosity the implementation process of the standards in these countries and was analysing the success of the framework. Nevertheless, new researches imply that the countries did not comply with these rules to such an extent as it was earlier believed. Even where formal compliance did take place the enforcement of the rules is problematic. Political economy theories imply that as these countries failed to implement good practices their economic growth has to be low. However, data show differently. I present the implementation process of banking and corporate governance standards in the cases of Korea and Malaysia. I argue that due to the Confucian characteristics of Capitalism in these countries compliance with financial standards is not crucial for the economic growth of these countries.

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Introduction

Malaysia and South Korea were among the countries that were most hit by the 1997 Asian financial crisis. However, throughout their recovering they followed different ways. While the government of Korea decided to accept the help of the IMF and committed itself to the implementation of the related program, the government of Malaysia rather decided not to use the IMF support and hence does not implemented the IMF recommendations. However, Malaysian economic policy was also conducted in an orthodox manner which in practice meant that the policies were I line with IMF recommendations.

The program of the IMF given as a solution of the Asian crisis included the convergence of the financial institutions of the affected countries to the structure of the international financial setup. The argumentation behind was that the main reason for the outbreak of the crisis was that the banking, corporate governance and auditing systems of these countries were not effective enough. In the eyes of the IMF these structures work correctly in case they are transparent, actors can access information about them easily and state plays only regulatory role in them. The last means that the IMF required the governments of these states to build up a strict and effective regulatory framework, secure that they are enforced by the judicial system. Nevertheless, it also obliged the governments to stop discriminatory intervention in the financial and corporate structure. This demand can be traced back to the earlier characteristics of the economic policy of East Asian countries. They were conducting so called export-oriented growth policies. It meant that the government provided support for those industries that could produce for good foreign markets hence were the drivers of the economy. Moreover, the government provided different domestic support to these companies as well. Mostly, it gave them access to extra loans in case they could not pay back their credits or they pressured the borrower banks to roll the non-performing credits over. This meant that the government intervened in the financial system from time to time. In the opinion of the IMF this made the system inefficient, hence the role of the state should be decreased. However, this was not without debate among the economic researchers. For example, Krugman argued that the role of the state should be increased because free markets provide such inefficiencies that are going to be resulted in the collapse of the system again.

Nevertheless, most of the countries did take the IMF support and were following the guidelines required. Even Malaysia ended up applying the standards even though it did not take the support of the IMF. Most of the literature argues that the countries managed to comply well with these rules. However, the new book of Andrew Walter[1] presents evidence that actually this compliance was good only formally and was problematic practically.

In my thesis I will analyse the impact of the compliance with banking and corporate governance standards on the economic growth of these countries. I leave out auditing standards because theoretical literature shows that it is the other two that actually determines the growth path. As countries did not implement good practice of corporate governance and banking supervision theoretical literature predicts that they have bad economic growth path. However, the examination of the data shows differently. I will argue the reasons lying behind this phenomenon through the cases of Korea and Malaysia. I chose these two countries because they were both strongly hit by the crisis and even though they chose different recovery path they both ended up with implementing the standards.

The structure of my thesis is the following. In Chapter one I shortly present the theoretical background of the role of corporate governance and financial institutions in economic growth. In Chapter two and three I present the cases of Korea and Malaysia. In Chapter four I argue the reasons behind the unexpected growth path.

[1] Walter, Andrew (2008) Governing Finance: East Asia's Adoption of International Standards, Cornell University Press, Ithaca and London

Chapter 1: Theoretical background

In this chapter I present the theoretical background assessing the relationship between financial institutions, corporate governance and long run economic growth. Theory implies that sound financial system is needed for sustainable economic growth.

1.1 Relationship between financial system and economic growth

Financial system and financial intermediaries play a central role in a modern economy because they are responsible for collecting the savings of individuals and transmitting them to the companies in the form of loans to finance their investments. In case this transmitting system does not function properly the capital flow becomes problematic in the economy which can result in high level of inefficiencies in the economy.[2] Nevertheless next to this basic function of mobilizing savings, financial system also serves other goals such as "facilitate the trading, hedging, diversifying and pooling of risk; allocate resources; monitor managers and exert corporate control and facilitate the exchange of goods and services.[3]

However, as Levine argues, financial institutions arise due to the existence of transactional costs and information shortages.[4] In case the system would operate perfectly in line with the Arrow – Debreu model no financial institutions would be needed. All in all Levine argues that financial systems arising due to transactional and information problems through exercising the above described functions affect capital accumulation and technological innovation through that they influence economic growth.

In order to establish the necessary theoretical framework for my analysis, in line with the analysis of Levine, I will describe how financial institutions can influence economic

[2] Zysman, John (1983) Finance and the politics of industry, in: John Zysman: Goverments, Markets and Growth, Cornell University Press, Ithaca, 55-95.

[3] Levine, Ross (1997) Financial Development and Economic Growth: Views and Agenda, *Journal of Economic Literature*, Vol. XXXV (June 1997), p. 691

[4] Levine, Ross (1997) p. 690

growth through assessing their functions one by one. First, I assess the risk management function. Since technological changes brought about by industrial revolution the companies need much larger capital for longer periods than earlier. From the point of view of investors providing big loans for long time means that the problem of liquidity risk arose, as they can not convert their assets during the transaction. Information asymmetries make the problem even more serious since the borrowers do not have the means to assess whether a company is going to experience shock. The solution comes from liquid capital markets. On the markets companies can always get the capital needed while investors can any time trade with their assets and thus secure liquidity even in case of long term commitments. This results in capital flowing to technology intensive sectors where big credits are needed and returns even though higher can only be realised in the long run. Nevertheless, not only capital markets can effectively handle the liquidity problem but "banks can offer liquid deposits to savers and undertake a mixture of liquid low-return investments to satisfy demands on deposits and illiquid, high-return investments. By providing demand deposits and choosing an appropriate mixture of liquid and illiquid investments banks provide complete insurance to savers against liquidity risk while simultaneously facilitating long-run investments in high-return projects."[5] However, banks only emerge to make investment in high-return illiquid assets possible if capital markets are not effective enough. All in all by diversifying risk and providing assets for high-return but long commitment sectors both capital markets and banks contribute to the emergence of technology-intensive activities that enhance technological innovation and through that drive economic growth. However, the disappearance of liquidity risk and the increase on certainty have ambiguous effect on saving rates and hence on economic growth.

Second, Levine argues the effect of the function information collection about investments and resource allocation. High cost of information result in low level of

[5] Levine (1997) p. 693

investments since savers are not aiming to invest into companies about that they do not have sufficient information. With forming financial intermediaries the problem can be overcome because not each individual investor has to pay whole information cost alone but a group can pay it together and then share it. It decreases information costs thus overcomes information acquisition problem and improve resource allocation. Consequently capital can flow into enterprises with highest chance to succeed hence where capital has highest value of use. This increases rate of technical innovation and leads to better economic growth path. Moreover through decreased information costs also improve capital allocation, hence fasten capital accumulation and enhance long run economic growth However, this information collection also has a public good aspect Capital markets provide information aggregated in prices which can be observed by such actors as well who do not take part in the costly evaluation processes. This encourage people to free-ride in information acquisition process that can result in the society not devoting enough resources on information acquisition and thus undermining the effectiveness of the process that can result in economic slow-down.

Third, Levine argues the effect of financial system on economic growth through its ex-post functions of monitoring and providing corporate control. Financial intermediaries such as banks aggregate the savings of numerous individuals and provide that to companies. This implies that they also allocate monitoring costs hence they do not have to be paid by individuals alone but can be shared among investors. Intermediaries also overcome the problem of duplicate monitoring and separate ownership and management resulting in efficient specialization. Moreover, individual savers do not have to monitor the intermediary because it secures its working via portfolio diversification. These features increase efficiency in the system hence promotes long run economic growth. Moreover, monitoring exercised by financial intermediaries also make long term relations possible that decreases information costs and enhances resource allocation. Monitoring is also possible via stock markets either by tying management compensation to stock performance that makes the interests of management and owners converge or via enhancing takeovers that motivate managers for good governance. However, insider shareholders can gain from information asymmetry between them and outsiders that can prevent good resource allocation.

Fourth, Levine discusses how financial institutions enhance economic growth via mobilizing savings. This can enhance economic growth clearly through enhancing capital accumulation and improving resource allocation, the effect of which I showed earlier.

In addition to the mechanisms argued earlier financial institutions also enhance economic growth through facilitating exchange. The idea behind this is that through decreasing information and transaction costs financial institutions facilitate transactions that are inevitable in case of specialised economic system. Specialisation allows for actors to exploit their comparative advantages and that leads to the increase of economic growth.

1.2 Relationship between corporate governance and economic growth

Corporate governance is important from the point of view of economic growth because it is closely related to the functioning of the companies that create economic performance. Corporate governance influences economic growth through affecting the effectiveness of the company.

One of the main concerns regarding corporate performance is caused by the principal – agent conflict between the shareholders or owners and the management. The problem is present because management has different interest than the shareholders of the company. The management is aiming to keep or improve its position and its power. If it depends on them they pursue their own interests even if the price is the shrinkage of the effectiveness of the company. Moreover, there is also an information asymmetry between the two parties since the management has insider information that owners do not have accession to. In order to overcome this problem first sufficient monitoring is needed that helps shareholders to become the information that is needed for them to be able to control the actions of the management and ensure that they lead such policies that are in the interest of the owners that is to make the company work as efficiently as possible. Second, the management board should be independent so that it considers the interest of the owners more. Third, shareholders should have sufficient rights that shelter them from the wrong-dings of the management and these rights should be well enforced by the judicial system. Finally, managers can be paid on the basis of the performance of the company, however, it is an ambivalent measure as I argued earlier.

Corporate governance of a country has strong influence of the resource allocation in its economy and the above mentioned features are present everywhere. However, there is no one best practice of corporate governance that could be applied to any economies.[6] There are different ways of conducting good corporate governance and it depends on the ownership structure of the economy, the legal traditions of the country, moreover, the characteristics of the sector itself where company is working. All in all, corporate governance system is deeply embedded in the institutional setup of the country, hence the framework influences which style is going to be the best practice.

Effective corporate governance is particularly important in case of financial institutions since they strongly affect the development path of a country. Moreover, the financial setup and the corporate governance style are dependent upon each other. It means that financial system and corporate governance method of an economy has to match to each other otherwise no sustainable development is possible. In case of organic development these institutions are going to come to existence in such a way that they complement each other. However, if

[6] Maher, Maria and Thomas Andersson (2002) Corporate Governance: Effects on Firm Performance and Economic Growth in: Joseph McCahery, Luc Renneboog, Piet Moerland, Theo Raaijmakers ed. Corporate governance regimes: convergence and diversity, Oxford University Press, Oxford, p. 386 – 420

systematic reforms are conducted in a country then the policymakers have to pay extra attention that these systems do not contradict each other. It is highly important if changes come from the outside such as in the cases of the East Asian countries' reform on the basis of IMF guidelines.

1.3. Conclusion

All in all theory clearly suggests that sustainable economic growth is only possible if the country has efficient financial and corporate governance system. Moreover, these two structures should also complement each other so that they can function in a sufficient way.

Chapter 2: Korea

Korea was one of the countries hit most hard by the financial crisis. The government in charge at the time of the crisis saw the problems with the large company conglomerates, the chaebols as the main cause of the crisis. It also had the opinion that the banking system problems were connected to these. Thus the government of Korea was fully committed towards the application of international financial standards.

2.1 Banking supervision

2.1.1 Background

The institutional setup of financial regulation was based on three plus two organizations. First, in April 1998 the Financial Supervisory Commission (FSC) was established. It was a policymaking body which had the power to supervise the restructuring of the whole financial and corporate system of Korea. Second, the Financial Supervisory Service (FSS) was established in January 1999 by merging four former supervisory bodies: Banking Supervisory Authority, Securities Supervisory Board, Insurance Supervisory Board, and Non-bank Supervisory Authority.[7] It was the executive arm of FSC, responsible for implementation and was supervised by FSC. The FSC formally supervised the working of the FSS, also meaning that the Chairman of FSC and the Governor of the FSS was the same person. Third, the Securities and Futures Commission (SFC) was put up as a part of the FSC. SFC has been responsible for the overview of market practices and together with FSC has the right to deliver instructions to the FSS. Furthermore, the Bank of Korea and the Korea Deposit Insurance Corporation – the latter established in 1996 – "… also have the right to

[7] FSS (2009) Overview, Financial Supervisory Service, Seoul , available at: http://english.fss.or.kr/fsseng/eabu/int/est.jsp?menuName=INTRODUCTION&menuIndex=0, accessed on 23 May 2009

require the FSS to examine banks or to demand that their employees participate in joint examination."[8]

2.1.2 Independence

The independence of the regulatory bodies can be however questioned on more grounds. First, the appointment of the staff was criticized by the IMF. The personnel were connected to both the President and the government and so to the political sector. In a nutshell the President has been responsible for the appointment of all the executives of the FSC on the basis of recommendations coming from the government. The positions of FSC Chairman and the FSS Governor, meaning the leaders of the two organizations, were held by the same person who was also an appointed cabinet minister. Moreover the Chairman of the SFC was the Vice Chairman of the FSC the same time.

Furthermore, the cases of Daewoo and Hyundai the two biggest chaebols also suggest that the financial regulatory agencies have not been independent from politics. In both cases the government took steps so that both domestic and foreign banks roll the loans of these companies over and the nationalized banks gave them extra credit. Both cases it is clear that the government directly interfered to save the companies from collapsing even though their performance was not sufficient anymore. When asked about these proceedings the President's office did not deny but explained that "[w]e are doing what is deemed necessary to save companies leading the country's strategic industries."[9] Moreover, the chairman of Hyundai was related to Kim Dae-Jung's "sunshine policy"[10] contrary to the chairman of Daewoo

[8] Walter (2008) p. 133

[9] cited by Walter (2008) p. 135

[10] South Korea turned to a milder approach towards North Korea during the presidency of Kim Dae-Jung (1998 – 2003) which is called the "sunshine policy". The aim was the development of peaceful cooperation between the two countries and to reach that South Korea was even willing to disregard certain features of the North Korean regime. The doctrine was effective in South Korea's foreign policy till the inauguration of President Lee Myung-Bak in 2008. Nevertheless, during the period when Hyundai needed the assistance of the government to overcome its business failures, Kim Dae-Jung was the president who supposedly supported such people who backed his approach regarding North Korea the implementation of which was not without criticism.

whose relationship to the government became antagonistic.[11] This could also play role in the different outcome of the two companies.

The picture partly changed in 2008 when the institutional structure was changed. The main features were the following. First and most importantly the functions of the Chairman of FSC and the Governor of FSS were separated. The FSC was renamed to Financial Services Commission (abbreviation remained FSC). Its basic structure stayed unchanged, yet two members are now recommended by the FSC Chairman and only one by the government and the FSS Governor also became ex-officio Commissioner.[12] The Governor of the FSS is appointed by the President but on the basis of the recommendation of the FSC Chairman and the preliminary approval of the Commission. [13] All in all the independence of the institutions increased as the functions of Chairman and the Governor were separated both from each other and from the function of cabinet minister and as the Chairman was given the opportunity to recommend two Commissioner. However, the independence has not yet become perfect because it is still the President of the State who appoints most of the personnel including the Auditor of FSS. The latter means that the control of the functioning of the FSS has remained close to politics.

2.1.3 Capital, Loan Classification, Provisioning

The Capital Adequacy Ratio (CAR) is a proper indicator of the stability and reliability of a bank. It shows the rate of "secure" capital to the whole assets of the bank adjusted by market risk and under the Basel standards should be minimum 8%. Korean financial regulatory bodies showed high commitment towards the adaption of capitalization standards. Not only did they define unofficial minimum CAR target in 10% by 2001 but they also adopt

[11] Walter (2008) p. 134
[12] FSC (2009) Commissioners, Financial Services Commission, Seoul, available at http://www.fsc.go.kr/eng/, accessed on 23 May 2009
[13] FSS (2009)

the necessary definitions. Moreover under the framework introduced in 1998 banks had to submit restructuring plans in case their CAR dropped under the required level.

Nevertheless, the implementation of capital standards was not without contradictions. First, Tier 2 capital was defined in a Basel-inconsistent way even in 1999. Second both before and after the grace period of adoption the rules were tightened and loosened in order to balance economic slowdown in 1998, 2000 and 2003. Third, after the collapse of Daewoo banks were reconstructed, however, they were not penalized in case they did not meet capitalization standards.

Loan classification system underwent similar relaxation and strengthening periods. Until the end of 1999 the classification practice was rather flexible even though the rules were formally tightened in April 1998. However, partly due to the Daewoo and Hyundai story practice remained loose to such an extent that "in August 1999 the head of the FSC even described HSBC's intention to apply international loan classifications standards to Seoul Bank (which it wished to purchase) as 'irrational'"[14]

The system was tightened in December 1999 when the banks had to adapt a strict US-style loan classification structure, yet, non-bank institutions could postpone the adaption of these rules until June 2000 as authorities were afraid of the impact on growth. Although these changes had visible effects on the banking system of Korea as possibly problematic loans surfaced[15] during the Hynix[16] story it became clear that loan classification remained more political than conservative. Moreover, the SME[17] sector continued to experience difficulties that suggest that NLPs remained underestimated.

[14] Walter (2008) p. 136

[15] Loans classified as precautionary earlier, became sub-standard, hence share of non-performing loans (NLP) increased.

[16] part of Hyundai group

[17] Small and Medium Enterprises

2.1.4 Other rules

Credit concentration and credit ceiling rules were strengthened in May 1999, meaning that credit a person or a company could get from a bank decreased. For example, earlier a "group borrower" meaning a chaebol could get credit up to 45% of the total capital of the bank but after 1999 the was decreased to 25% which was already consistent with the Basel Core Principles.[18] The same for a single individual or juridical person was set at 20% which meant a decrease in case of payment guarantees (from 30%) and an increase in case of loans (from 15%).[19]

However, the introduction was again contradictory. The rules were effective as ok 1 January 2001, yet, banks could exceed the official ceilings until end of 2002 in case of "unavoidable reasons" related to the "Fast Track Program" of the government which was to refinance major firms' maturing bonds. Moreover, Korea Development Bank which was state-owned and served as the biggest lender to chaebols were given a grace period until the end of 2004 and had to fully implement the credit ceilings only afterwards.

Even so, credit concentration reforms did have effect on Korean financial system. "Bank lending to chaebol as a percentage of total loans fell from 25 percent to 24 percent over 2000 to mid-2002, as foreign ownership in the banking sector increased and as most banks focused on more profitable consumer lending."[20]

All in all Korea clearly showed commitment towards the implementation of international financial standards. In case3 of loan classification and bank provisioning

[18] BCBS (1997) Core Principles for Effective Banking Supervision, Basel Committee on Banking Supervision, Basel

[19] Walter (2008) p. 138

FSS (2000) Financial Supervisory System in Korea September 2000, Financial Supervisory Service, Seoul, p. 56

[20] Walter (2008) p. 139 - 140

compliance went further than in any other East Asian country. It was partly the cause of the privatization process which resulted in the above mentioned increase of foreign ownership in the banking sector. Banks with international network naturally implemented the rules that were effective in all the subsidiaries of the bank. Due to the international features of such banks these rules were closer to international standards than the one of Korean owned banks.

The problems regarding the compliance of Korean financial institutions were mostly the effect of the contradiction the government faced. The authorities were on one hand committed to use the crisis to transform the financial sector of Korea and to rule out systematic problems that played role in the escalation of the crisis. On the other hand, they naturally also wanted to promote economic growth and financial stability and wanted to avoid the rise of unemployment. The latter goals were however not achievable in case of drastic and fast financial restructuring. As a result the authorities took political decisions from time to time which they believed to be necessary to preserve economic growth even if the price was to delay compliance with financial standards.

2.2 Compliance with corporate governance rules

2.2.1 Background

Different actors took contradicting approach to the application of corporate governance standards. The Kim Dae-Jung government being in force after the crisis was strongly committed to the implementation of the standards because of the conviction that the poorly managed chaebols were one of the main reasons of the outbreak of the crises. Domestic business actors were strongly opposing most of the changes and through their lobbying they got support from certain political actors. Foreign business actors were in favour of compliance but did not have the power or the influence to enforce them. The interaction of these actors played strong role in the compliance outcome of Korea.

The first letter of intent was issued in December 1997 and included general commitment. It was in the amendments issued later on that contained more detailed duties most of which was aiming to move Korean corporate governance system towards the Anglo-Saxon style. Kim Dae-Jung believed that to be the appropriate way to decrease the economic and political power of chaebols. In December 1999 the “five principles for corporate reform” were put in force which is important as it was the result of an agreement between the government and the main chaebols. Nevertheless, most of the reforms were based on the analysis of the Korean Committee on Corporate Governance (KCCG) written between March and September 1999. Finally the government ordered a foreign consultancy report which was prepared by May 2000 by a group lead by Bernard Black. The approach of the Black Report was in line with the Anglo-Saxon style. Whereas, it also emphasized the difficulties that can surface during the implementation project. They are mostly due to the above mentioned differences among the approach of different actors. The chaebols that strengthened their market position in the important sectors through earlier mergers and their main shareholders would have to hold most of the costs of the compliance. However, it is exactly them whose interests lie in the maintenance of the status quo. Moreover, they had political influence as well through funding the campaigns of political parties mostly that time opposition conservative party which as a consequence in the parliament vetoed the reform aspirations of the government from time to time. The business organizations, think tanks and newspaper industry dependent upon chaebol advertising revenues also promoted the approach of the chaebols namely that international actors are aiming to undermine the competitiveness of Korean economy through making it comply with international standards.

2.2.2 Board independence

“Despite chaebol opposition, the Commercial Code was modified in December 1998 so as to define more clearly the nature and responsibilities of directors, to establish their fiduciary duties and to increase the penalties for dereliction of duty."[21] In 1999 the KCCG adopted that to minimum 25% of the board independent directors have to be appointed. This was much smaller share than the U.S. standard and also half of the limit for Korean banks. In 2001 the Korea Stock Exchange (KSE) made minimum 50% independent directors for all large listed companies obligatory.

The result was formal compliance on the side of companies. Surveys also showed that formally independent executives were not such in practice making Korea the worst among Asian countries in this respect. First, family shareholders generally play dominant role in the selection of executives. Second, the so called independent executives are usually previous directors of firms related to the company. Third, CEO and chairman positions are usually held by the same person which further strengthens the power of family shareholders. Finally, even if the directors are independent in practice as well they do not have the sufficient information about the company.

2.2.3 Board committees

The rules regarding Board Committees were rather loose as well under the recommendations of KCCG. The Boards were left to decide if the establishment of internal committees are necessary. It was only large companies and banks that were encouraged to form internal audit committees with two-third of the members including the chairman elected from the independent directors. In 2000 the KSE obliged again only large listed firms to form audit and nomination committees, the former with at least one member having experience and professional knowledge in corporate accounting. This was in line with the U.S. and U.K. regulations.

[21] Walter (2008) p. 145

As a result part of company boards adopted internal committees, however, even the established ones were ineffective, due to scarcity of independent directors. Even in case the executives are truly independent they lack the necessary information and expertise. It is also clear from the fact that nominations committees did not manage to break the family inheritance lines of senior management.

2.2.4 Shareholder rights

Although in some areas Korea is one of the countries with the strictest rules, the results have rather been formal than practical regarding shareholder rights as well. This was the consequence of the earlier mentioned conflict between the interest of different actors. A good example is the case of cumulative voting. On the basis of the Black report the government wanted to introduce cumulative voting, however the business society was against it and got the Parliament vote against the proposal. This resulted in the rules establishing an optional possibility for cumulative voting even though it would have been necessary in order Korean companies comply with other standards too.

Shareholder rights were also overshadowed by the lack of Board independence. Shareholders meeting have carried on being rather short and perfunctory, for example any transaction bigger than 1% of revenues and assets have to be approved by the Board and not shareholder meetings which is a rather low limit.

In order to overcome weaknesses of the shareholder rights the government was aiming to enhance for outsiders, meaning both foreigners and shareholders not related directly to the company to sue companies. The KCCG was against this because of the possible costs of "excessive claims". In December 1998 for listed companies only the minimum requirement for suing the majority of shareholders was reduced from 1% to 0.01% of all the shares. October 2000 the government announced its intention to introduce U.S. system of class action suits. Business lobby against opposed it claiming that it would make shareholders enter into wasteful actions much easier hence would decrease the effectiveness of management. In the end the system was introduced for the largest firms as of January 2005 and for all listed companies as of January 2007. The changes have had limited effects because Korean society has stayed uninformed of the changes. On the other hand foreign investors who were aware of their rights usually blunder into the problem of the concentration of control which makes real changes, e.g. removing directors, impossible. The few occasions and small signs of change is the consequence of the increase of foreign ownership in Korean companies[22] and the work of domestic investor right activist groups.

2.2.5 Corporate governance in financial sector

Corporate governance rules have been much stricter for banks because it makes their monitoring of borrowers more effective. For example they were obliged to have 50% independent directors in their board and to have audit committees with at least two-third of their membership being independent directors. Ownership control have been in place since 1982 and was even loosened after the crises by increasing the ceiling of an individual's possible property to 10% of the total shares of a bank with exception of the case when they were injecting capital as a part of the restructuring and recapitalization process. These and other attempts of the government and the increasing foreign ownership in the sector have been improving corporate governance in the financial sector. However, Korea is still lagging behind in comparison to the financial sector of other East Asian countries. Moreover the good practice has not spilled over to the corporate sector which is the major problem of the process. It is mostly due to chaebols effectively controlling the markets for external financing of the companies which sets banks back in controlling the corporate governance of companies.

[22] This has become 40% on average by the end of 2003.

Moreover, corporate governance practices have stayed underdeveloped in state-owned banks which provide most of the credit for big companies.

2.3 Conclusion

All in all compliance with corporate governance standards has remained limited in Korea compared to other East Asian countries due to the tensions between the actors meaning also that families continue to control the biggest companies. The growing share of foreign ownership could not improve the situation significantly either as the chaebols were successful in promoting the idea of the need of national resistance against foreign control force to the country through the standards. In banking sector where the influence of chaebols is smaller and foreign ownership is bigger the situation has been much better but still lagging behind other East Asian countries.

3. Malaysia

Malaysia was next to Korea the country most hit by the 1997 crises.

The case of Malaysia differed from Korea in several respects. First, it was the only country in East Asia that did not accept the support of the IMF hence did not dedicate itself to following the IMF guidelines. Even though it ended up with rather orthodox line of economic policies as Walter also shows it. Thus even though the Malaysian government initially took distance from the IMF approach it ended up implementing policies in line with the IMF recommendations. Second, as opposed to Korea which had bank-based financial system the Malaysian financial structure was a rather developed capital market-based system. Third, Malaysian political power was centralized to a high degree and judiciary bodies were subordinated to them. As Walter argues, it made execution much easier on one hand and the attitude and the approach of the government much more important on the other hand.[23]

3.1 Banking supervision

3.1.1 Background

The framework for the implementation of banking standards was already established before the crisis. The first step was taken in 1986 by giving the Bank Negara Malaysia (BNM) powers to regulate and license financial institutions. Moreover the Financial Institutions Act in 1989 created a sustainable and robust regulatory framework. It was successful in decreasing the dependence between banking and corporate sector by limiting the share of ownership a bank can have in non-financial companies and forbidding banks to have membership in company boards. The market-based style of the financial industry enhanced these arrangements as banks originally had had smaller influence than in other countries.[24] As

[23] Walter (2008) p. 99

[24] Meeskom, Kanitta et al. (2001) Malaysia: From Crisis to Recovery, Occasional Paper No. 207, IMF, Washington DC p. 4-5

Walter notes[25] there were some exceptions. For example, Bank Bumiputera Malaysia (BBM) which was established in 1966 and became really powerful in 1970 during the New Economy Policy that was promoting bumiputera business.[26] BBM was the bank that provided loans for these entrepreneurs and hence had the political backing for avoiding the intervention of the BNM. Another example was the bank mergers in the 1990s during that the BNM did not manage to enforce the limit that a single shareholder could own in a commercial bank also because leading members of the ruling party were involved as well. These cases resulted in the decline of the reputation and supervisory mandate of the BNM and the erosion of the system.

The institutional framework remained based on the BNM and the Minister of Finance who both had the right to recommend regulatory guidelines. Hence the person of the Minister of Finance has been inevitably important. At the outbreak of the finance it was Anwar Ibrahim was holding the position. He was the one who opposed the IMF intervention and decided to solve the problems without its help. He was committed to orthodox economic policy and was aiming to restructure the financial and corporate sector indigenously. Walter argues that[27] Anwar's relation to Prime Minister Mahathir bin Mohamad began to loosen when Anwar's provisions began threatening the New Economic Policy of the Prime Minister by making banks lend less to non-performing companies. Mahathir began to realize that the neoliberal framework Anwar was promoting threatens his New Economic Policy program. Moreover, Anwar's fight against nepotism and cronyism threatened the position of Mahathir himself. This ended in his replacement in September 1998. He was succeeded by Daim Zainuddin who was one of the richest and most influential bumiputera businessmen that time,

[25] Walter (2008) p. 102

[26] Bumiputera is the name of the indigenous people of Malaysia. The New Economic Policy was aiming to promote their role in the business life of Malaysia. Earlier they had been overshadowed by dominant Chinese businesses. Consequently, poverty was more prevalent than among Chinese minority. The government was aiming to change that by promoting bumiputera businesses.

[27] Walter (2008) p. 103

owner of one of the biggest banks and closely related to the Prime Minister. He stayed in this role until 2001 when the Prime Minister had to dismiss him after the party lost many places on the elections clearly as a consequent of the policy Daim was following. Prime Minister Mahathir himself took the position of the Minister of Finance that time. The next change was already due to the failure of Mahathir. All in all it was until September 1998 that the Minister of Finance was truly committed towards the adoption of rules and standards needed for orthodox economic governance.

3.1.2 Independence of Regulators

The execution of financial regulation has belonged to the BNM. As Walter argues[28] the BNM has never actually been independent from the government and Malaysian governments have never aimed to assert the contrary. Both the governor and the deputy governor of the BNM have been appointed explicitly politically and usually have been outsiders and not a former executive at BNM. The governor has usually been involved in other institutions related to the economic policy of the government. Moreover the Ministry of Finance Secretary-General have had ex-officio membership in the board. Due to these interlocking it was impossible for the BNM to act independently from the government.

After the crisis the BNM increased the number and the frequency of bank examinations in order to rule out inefficiencies. This was also aiming to eliminate NPLs from the system which was growing after the crises. This threatened mostly the bumiputera businesses that accumulated most of the NPLs under the New Economic Policy. This occurred to Mahathir as well and resulted in Anwar’s sacking that I described earlier. It is important to emphasize here that the system was under pressure due to the high level of concentration of NPLs. During the New Economic Policy bumiputera businesses got assistance to grow. This occurred partly

[28] Walter (2008) p. 103

through securing that they got bank loans even if their performance would not have allowed so.

The restructuring of the banking sector was conducted through the recapitalization of the sector and mergers of banks. Walter argues[29] that was rather transparent in case of banks but not in case of companies connected to the governing party.

Walter discusses[30] that after 2001 and the sacking of Daim from the post of Minister of Finance the independence of the BNM showed improvement. However, it kept on shifting on the basis of the preferences of the actual government. The banking sector consolidation was an example that clearly showed that BNM remained politically subordinated. The original plan was to establish six strong independent financial institutions as the basis of the financial system. However the founding of such strong banks would have threatened owners of existing banks both bumiputera and Chinese. The result was that the government increased the number from six to ten which also meant that then newly established institutions were much weaker than originally planned.

3.1.3 Capital Adequacy, Loan Classification and Provisioning

Walter argues that Malaysian banks showed good compliance with capital adequacy rules. Minimum CAR has been 8% since early 1990s and banks were encouraged to target higher shares. Definitions of different capitals were also applied in line with the Basel principles. However the definitions were relaxed discretionary from time to time for example in September 1998 after the sacking of Anwar in order "to allow banks breathing space"[31] Not only were the definitions substandard and lower level loans loosened but rescheduled loans could be admitted as performing easier and minimum lending targets for banks were

[29] Walter (2008) p. 104
[30] Ibid.
[31] Walter (2008) p. 105

introduced. It meant that the bad loans of bumiputera companies that had to be rolled over could have been settled as normal loans being part of the secure capital represented by CAR. It is clearly against the solvency and liquidity of the banks since credit provided to firms not having proper economic performance hold high level of risk. However, banks remained with the earlier and stricter definitions as Walter argues.

All in all rules on loan classification provisioning and NPLs have been loosened and tightened periodically. In 1999 for example they were loosened to enhance the decrease of NPLs in the system but in 2000 and 2001 they were tightened again in the framework of the reconstruction of large corporations.

3.1.4 Other prudential rules

Walter argues that most of these rules were made conform with international standards.[32] Lending limit for single borrowers was decreased from 30% to 25% in line with the Basel Core Principles. Since 1989 bans were prohibited to give loans to directors, staff and their associated companies. This was extended to controlling shareholders and/or influential shareholders in 1999.

3.2 Corporate governance

3.2.1 Background

Walter argues that Malaysian corporate governance system was closer to the Anglo-Saxon model than any other Asian countries including Korea as a consequence of its British inheritance such as market-based financial system and common law.[33] The country had already adopted many of the standards before the crisis. For example listed companies were required to appoint independent directors and audit committees with at least one independent director and once audit expert. However, family ownership and cross-shareholding was also

[32] Walter (2008) p. 108
[33] Walter (2008) p. 109

present in Malaysia. Moreover, government and business was also not independent from each other. Government was holding controlling stakes in many big companies. The government – business ties have been one of the main problems of Malaysian corporate governance.

Moreover Walter discusses that increased bumiputera participation was also visible as a result of the New Economic Policy.[34] The target set by 1990 was "a minimum quota of 30 percent equity participation and employment for bumiputeras in companies with at least RM100.000 in share capital and 25 workers."[35] It means that companies were obliged to have bumiputera shareholders and employees. In the beginning it was exercised through disadvantaging foreigners. Later, however, growing state ownership was used to give bumiputeras stakes. Finally, Chinese entrepreneurs were also deprived in order to promote bumiputera business. Mahathir also used the control of the party to transfer assets to bumiputeras. All in all a clear tension appeared between the opened regulatory framework and the discriminatory manner of the New Economic Policy.

Here we can again see a problem of the collision of different actors involved in the corporate governance regulatory framework. However, as opposed to Korea the government was not committed towards tie adoption of the corporate governance standards but was trying to promote the ownership and business interests of the indigenous people. This resulted in a rupture inside of the society between Chinese and bumiputera people and in collision between foreign actors and indigenous citizens. Interestingly, however, Malaysia still shows higher level of compliance with corporate governance standards than Korea. This is due to the fact that the starting point was much better than in Korea and the whole system is closer to Anglo-Saxon style the international standards are based on.

[34] Walter (2008) p. 110
[35] Ibid.

Walter argues that the regulatory framework was developed by two institutions the High-Level Finance Committee on Corporate Governance and the Kuala Lumpur Stock Exchange (KLSE). The Malaysian Institute of Corporate Governance was also established in order to promote international standards.

3.2.2 Board Independence

Walter argues that in Malaysia at least the highest of one-third of the Board or two directors had to be independent. "'Independence' means that such directors cannot be linked to family ties or substantive business relationships to senior management or major shareholders."[36] Companies were also recommended to separate the positions of chairman and CEO the lack of which has cause big influence of family shareholders in Korea. The maximum number of Board members was set in 25 people which is a rather high number. Minimum number of meetings or attendance reporting was not required. This means that even though boards could be much bigger than international best practice would imply but it lied with the management to decide what it means to call them together regularly, moreover, in case board meeting was held the absence of any share of the board did not have consequences. It implies that decisions could be made even by leaving out part of the board.

Members of the board have been given opportunities to take part in personal trainings in order to secure their professional expertise knowledge. Large firms even offered extra trainings.

Walter argues that practical compliance with these rules was reasonable, meaning that compliance was higher than in many other Asian countries such as Korea. However, families and state continued to keep companies close. It was possible for example through that

[36] Walter (2008) p. 111

controlling owners appointed shadow directors who represented their interest in the board even though counting as independent executives.

3.2.3 Board Committees

As I argues earlier the establishment of audit committees with at least one independent director and one audit expert has already been required in Malaysia before the crisis. However, Andrew discusses that surveys show that in 1999 in practice these committees did not have independent membership, sufficient level of expertise or information. The picture have improved later on.

Remuneration and nomination committees were only recommended, however by 2002 three-fourth of the listed companies established such. This was far the highest in the whole region

3.2.4 Shareholder rights

Walter argues that shareholder rights were formally well protected. Problem arose because of the potential exploitation of outsiders by block shareholders. For example transactions representing more than 5% of the assets of the company have to be announced at the KLSE and have to be approved by 50% of the shareholders. However, ownership is concentrated in Malaysia to such an extent that it did not provide real protection to minority shareholders. Minority shareholders also have to approve inter-group transactions and an independent advisor has to decide whether the transaction was fair to all shareholders. Listed companies are also required to make quarterly reports to inform their shareholders. In 1998 measures to increase transparency were implemented to win back confidence of capital markets.

The rules are enforced by the Securities Commission (SC) in case of non-financial firms and by the BNM in case of financial companies. Shareholders can sue companies in case of directors failing to meet their responsibilities or the company providing misleading information. However, board elections are still dominated by controlling shareholders which in the end result in the exploitation of outside shareholders. Moreover, there is no requirement for cumulative voting in boards which further increases the power of majority shareholders.

Shareholders also face problems when wanting to sue the company. First, class action suits are not available which multiplies the cost of going to court since each shareholder has to represent themselves. Moreover, enforcement at courts is rather difficult mostly because enforcement lies in the hand of the state as the board of SC is mixed and contain subordinates of the Minister of Finance who also plays rule in establishing the rules. Consequently, the executive and the regulatory arms are not separated which can make enforcement highly difficult.

The special problem with bumiputera businesses in Malaysia adds one more dimension to the problem. As Walter argues enforcement is not only difficult to bring through but is also uneven.[37] Bumiputera entrepreneurs have preferential situation and gain much more during the enforcement process a s consequent of the government policy towards them. It naturally disadvantages outsider and foreign shareholders who would need most of the protection. This feature was partly overcome after the sacking of Daim in 2001. All in all the effectiveness of enforcement remains dependent upon the aims of the political leaders.

3.2.5 Corporate governance in the Banking Sector

For financial institutions BNM is responsible for enforcing and has had to take proactive measures since the crisis. Walter discusses that banks were required to have at least one non-executive member on the board.[38] Moreover as of June 2003 they have obliged to establish remuneration, nomination and risk-management committees the latter composed of

[37] Walter (2008) p. 117
[38] Walter (2008) p. 118

only non-executive members. “Banks are also encouraged to make public disclosures on board committee membership, qualifications, responsibilities and director attendance at meetings. Minimum qualifications and training for directors of banks were also specified in addition to existing ‘fit and proper’ criteria. Personal holding political office may not act as directors of financial institutions. BNM supervisors assess management and director performance in these areas among others. In August 2003 BNM required the rotation of bank auditors every five years, audit committee approval of the provision of non-audit services by auditors, and BNM approval of auditor reappointment … The new 2005 Guidelines require separation between CEOs and Board Chairmen and between shareholders and management.”[39] Next to BNM Danamodal and Financial Sector Master Plan played role in the regulation of banking corporate governance.

Walter argues that corporate governance of banks has considerably improved since the crisis. “Those banks best known for serious governance failures before the crisis, notably Bank Bumiputera and Sime Bank, were merged with others and management was replaced.”[40] Banks have clearly been performing better in compliance with corporate governance standards than non-financial companies. Banks have been showing above average level of compliance, however, domestically owned and state banks have continued to dominate the system that overshadows the results in other dimensions.

3.3 Conclusion

Compliance with banking supervision standards has been less strict in case of Malaysia than in Korea. The regulators are more dependent on the government mostly after the 2008 reforms in Korea. Rules on capital adequacy, provisioning and loan classification have also

[39] Walter (2008) p. 118 – 119
[40] Walter (2008) p. 119

been looser in Malaysia. The limit for single borrowers is the only set of rules with the same level of compliance in both cases.

However, compliance with corporate governance standards has been more successful in case of Malaysia. Actually Walter argues that the level of compliance has been very high and achieving the best score in the region in 2002.[41] Nevertheless, the level of enforcement and the political or regulatory environment have been on low level and this has not changed considerably after 2001 either as opposed to what many researchers argue.

[41] Ibid.

4. Applying Confucian Capitalism

The earlier two chapters showed that both Korea and Malaysia showed partial compliance with international banking and corporate governance standards or "mock" compliance in Andrew Walter's term[42]. It means that the countries complied more than only superficial formal way with international standards, however they did not reach the level of full or as Walter puts it "substantive" compliance. Hence these countries stuck somewhere in between with implementing parts of the standards and avoiding the rest. Walter shows the reason for this outcome which I partly presented as well.

Theoretical literature implies that without enforcing the standards needed for "good" financial system and banking supervision the economic growth of the examined countries can only be limited. However, when looking into the data it becomes clear that these two countries have been following an average growth path. In this chapter I am aiming to show the reasons lying behind such behaviour. After presenting the data I will show the reasons of this outcome first in case of corporate governance, second for financial institutions

4.1 Data analysis

In order to assess economic growth I use the GDP growth rate data of World Bank.[43] GDP growth is a general indicator of the economic development of a country. I use this data for my analysis because I am interested in the universal scheme of the economic development of these countries. More detailed data would also measure for other variables such as the structure of the economy, the composition of the GDP etc. However, my intention is not to conduct detailed research on the influence of financial standards of certain sectors of the

[42] Walter (2008) p. 32

[43] World Bank Quick Query (2009) available at http://ddp-ext.worldbank.org/ext/DDPQQ/member.do?method=getMembers&userid=1&queryId=135, accessed 30 May 2009

economy but to examine how they shape the overall economic development of the country. Hence using data that separates other variables as well causes unnecessary complications.

Graph 1 presents the growth data of the two countries from the outbreak of the financial crisis 1997. The first we can clearly see is that economic growth has been moving together in the two countries with the exception of years 2000 and 2003 after the crisis.[44] Moreover, the growth rate of Malaysia has been higher than that of Korea except in the four years after the contraction caused by the crisis in 1998. Thus Korea recovered faster in the short run after the crisis than Malaysia. This could be seen as evidence that the IMF program was effective because these two countries were the most hit by the crisis and the one taking the IMF assistant showed faster recovery path. However, as of 2003 the relative situation of the two countries changed and it was Malaysia that began to grow faster. This implies that in the medium run Malaysia has bigger growth potential than Korea.

However, it has to be noted that Malaysia and Korea are not on the same level of development. The IMF ranks Korea as a developed economy and Malaysia as an emerging country.[45] According the World Bank Korea is a high-income country, whereas, Malaysia lies in the category of upper-middle income countries. [46]As the two countries represent different levels of economic advancement their growth has to be considered accordingly. Graph 2 shows economic growth for Malaysia and South Korea, average economic growth for developed and undeveloped economies and average growth for all economies.[47] The diagram shows that with the exceptions of 1998 and 2002 the economic growth of both countries have been above the average of the economic growth of advanced and upper income emerging

[44] Deep analysis of the data is not inevitable for presenting the findings of this article, hence I do not argue here the events that led to the outlier observations.

[45] IMF (2009) World Economic Outlook April 2009, International Monetary Found, Washington DC, p. 184

[46] World Bank Quick Query (2009)

[47] Countries in the examined groups of developed and undeveloped countries were selected on the basis of the ranking of the IMF and the World Bank.

countries. Moreover, the economic growth of Korea has exceeded the growth rate of developed countries and the rate of Malaysia has exceeded the growth rate of upper income emerging countries. All in all, according to the data it is not true that the economic development of Korea and Malaysia have been slow or pressed down. This contradicts the findings of the theoretical literature presented earlier which argued that for sustainable development good practices in financial regulation and corporate governance are inevitable.

4.2 Role of Confucian Capitalism

The Varieties of Capitalism (VoC) approach offers alternative methodology for the research of certain sectors of an economy. The VoC builds on the actors in the economy and their behaviour. It argues that the multiple actors involved in economic system all behave rationally and try to find solutions that serves their interest the best. The interaction of these actors establishes the political, societal and economic structure and framework of the country. In order to find the policies a country should implement in order to follow a sustainable and effective development path the political, societal and economic framework must be taken into account. Hence, there is no one best practice that should be implemented in case of any countries. In economies with different framework actors need to behave diverse ways in order to maximize their utility. This implies that the policy for good economic growth cannot be the same either.[48]

The actors' diverse behaviour also results in the development of different economic institutions[49] in these countries. As institutions set the rules of the economy, their diversity results in different behavioural of the actors which implies that efficient policies will also differ. Hence, there is no one and only best practice that is applicable to all countries but the solutions leading to sustainable growth vary according to the institutional framework of the

[48] Hall, Peter A. and David W. Soskice (2001) Varieties of Capitalism. Oxford University Press, Oxford

[49] I use the term economic institution the way as Douglas North defined it, meaning the rules and customs of economic behaviour.

economy. It is even truer, if we consider the phenomenon of institutional path dependency. It means that institutions change slowly and gradually over time meaning that once they exist they define the economic framework in the long run.

I present an explanation of economic development in Korea and Malaysia on the basis of this approach. I argue that the features of Confucian Capitalism provide such a framework in these countries that result in financial standards being inefficient in their economies. I do not claim that these standards are absolutely unnecessary. However, they are developed by Western countries that have many common features in their capitalism. The standards are based on best practices that developed in these countries thus they can effectively function in the framework provided their. However, the style of capitalism in Malaysia and South Korea in many aspects differs from the Western type of capitalism.

4.2.1 Confucianism in Malaysia and South Korea

Numerous factors are responsible for the different setup of these two countries including historical development path. One of the most important features is philosophical diversion from European and North American countries. Philosophical traditions of a country or a region can seem to be irrelevant from the point of view economic development. However, philosophical streams determine the way of thinking of individuals consequently their behaviour as economic actors and the style of economic institutions built up by them. Due to institutional path dependence the current setup of economic institutions depend on their earlier development path and the functioning of their antecedents. As institutions all developed from small units operated by individuals and are further operated by individuals at any point of time, the behaviour of the members of the society partly determine the functioning of institutions. Moreover, earlier in the history philosophy, religion and politics, economics were not separated in a way that they are in modern societies. Consequently, philosophical developments also had direct effect on politics and economics. These traditions were practiced for a long time and left deep impact on the institutional setup of regions.

In East Asia the strain of philosophy determining politics and economics have been Confucianism.[50] As it is clear from everyone Confucianism is originally a Chinese stream of philosophical thinking hence the question arises, how is it applicable to the cases of Malaysia and South Korea. There is high Chinese impact in the whole East Asian region not only in these two countries because for centuries China was the dominant power in the region. As such it influenced its neighbours to a high extent on one hand as example of governance of the other countries, on the other hand through the pressure its power meant. Moreover, due to the special role of China in the region there has been high level of emigration to the neighbouring countries which resulted in the development of numerous Chinese minorities in most of the countries of the region. All in all, the teachings of Confucianism were spread around in the region not only through the cultural exchange and power politics but also directly via Chinese immigrants. It is important to note that in China Confucianism was for a long time the thinking that determined the rules of politics, state governance and economics, societal life. Thus Confucianism was not "only" a philosophy that individuals practiced in their life but it was rather the logic and set of rules determining public life. It also spread to the countries of the region in this form.

Particularly in Malaysia and South Korea the influence of Confucianism is clearly present. In case of Malaysia as I argued before the influence of Chinese minority was so strong that the government even felt need for adopting measures that benefits the businesses established by indigenous people. This proves that Chinese immigrants and their understanding of public interactions have had strong impact on Malaysian society and

[50] Confucianism is not a religion in the Western understanding of the word hence influenced societies differently as for example Christianity influenced European developments. I do not argue here the details of this phenomenon or the characteristics of philosophies of Chinese universalism.

particularly in the business life. In South Korea a new strain of Confucianism developed over the centuries that is present everywhere in the life of Korean society. Even though today most of the citizens does not define themselves as Confucian, the tradition is so deeply embedded in the society that all parts of public life are inevitably influenced.[51]

I will interpret Confucian Capitalism through the work of Souchou Yao.[52] He argues the functioning and structure of Chinese enterprises and through them discusses the main features of Confucian businesses and enterprises. His analysis concentrates on the micro level, however the structures he presents are clearly applicable to the macro level as well, hence his work can provide a good starting point for my analysis.

4.2.2 Corporate governance and Confucian Capitalism

In Chapter 2 and 3 I presented, how and to what extent Malaysia and Korea complied with international corporate governance standards. The results showed in line with the Walter's research that both countries reached the level of "mock" compliance, meaning that even though they formally adapted the necessary rules, the implementation of them was not perfect, hence the practical results and consequences are limited. Moreover, the analysis showed that Malaysia did better in compliance with corporate governance rules. Andrew argues that in comparison with the possible outcome and the other countries of the region Malaysia reached middle and Korea low level of compliance with corporate governance standards.[53] In this subchapter I will argue, why is it possible that even though the countries' results in compliance was considerably limited, their economic growth though remained higher than average during these years. My argumentation presents that the values and

[51] Koh, Byong-ik (1996) Confucianism in Contemporary Korea. In: Tu Weiming ed. Confucian Traditions in East Asian Modernity, Harvard University Press, Cambridge

Chang, Chan Sup (1998) The Confucian capitalism: Impact of culture and the management system on economic growth in South Korea. *Journal of Third World Studies*, Vol. 15. No. 2, p. 53 – 66

[52] Yao, Souchou (2002) Confucian Capitalism: Discourse, practice and the myth of Chinese enterprise. RoutledgeCurzon, New York

[53] Walter (2008) p. 169

structures of Confucian Capitalism does not match the standards, hence the two countries could develop corporate governance structure that matches their economic structure thus can function effectively. Therefore, I present the features of Confucian Capitalism and link them to the corporate governance system of the two countries.

The first important phenomenon of Confucian Capitalism that Yao argues is the so called "kan dian" which means "watching shop".[54] Yao argues that the Chinese shops are actually the space where all activities of life are conducted, hence, the sphere of business and social interactions, business and family are not separated. Thus financial success of the business and collective prosperity are tied together. It is not disclosed but represents a dynamic relationship where consensus and cooperation defines interactions and relations. In this space the owners of the business and the workers rebuild the model of the family, meaning that the employees are handled as if they were family members. This results in the "manager" the leader and owner of the shop behaving in a paternalist way with the actually non-family-member workers as well. "Kan dian" means that the owner of the shop fulfils management, authority and monitoring functions not only over the shop but over the workers as well. Nevertheless, employees do not see this as something against logic but as the natural duty of the owner. However, they feel it humiliating to some extent as it is actually about the insiders checking the outsiders who do not belong to the family. Hence even though family structure is rebuilt in business outsiders are never considered on the same level as family members. Due to the function being pressed on the workers, the owner needs the power of sanction in order to be able to effectively implement "kan dian".

The "kan dian" factor has numerous consequences on corporate governance in Confucian Capitalism. First, business is not considered as something separated from private life. Employees and executives do not think that the two spheres can be separated in a way

[54] Yao (2002) p. 93

that it is separated in Western cultures. They believe that their prosperity and the overall prosperity of the collective, the society depends on the financial success of the company. This results in a much closer and more internalized relationship between the firms and their employees. This phenomenon determines a basically different approach towards business life than in Western societies. People feel being part of the business like being part of a family since they build up relations associated with the structure of the family. Consequently, they consider themselves involved in the life of the business, they internalize the company and they feel as insiders of the firm. This is the reason for Korean and Malaysian company boards not electing truly independent directors or audit committees with independent experts. In their point of view such people are outsiders that mean a threat to the company because they do not internalize the goals of the firms hence cannot effectively represent them. In case they get executive function in the company they can bring the business down by not sacrificing their personal needs for the firm but trying to get private gains from it. Moreover, it also shows why Korean and Malaysian companies prefer family ownership to any other form even though in Western countries that form of ownership was overcome due to its effectiveness problems.

Second, “kan dian” implies a different system of monitoring than Western companies implement. First, in case of the monitoring of the Confucian firm, it is the insiders, the owner who monitor the outsiders. In case of Western type of monitoring system the inside functioning of the company is observed in order to give information to the shareholders who are outsiders, hence do not get access to sufficient information. The two systems clearly contradict each other, since the former takes into account the rights and interests of the insiders and protects those from the outsiders, while the latter protects the interests of the outsiders as opposed to the insiders. Consequently, a system that works on the basis of Confucian Capitalism is going to resist measures developed for the Western system.

Consequently, companies of Confucian Capitalism does not elect audit committees because they do not see the point in having outsider monitors. In these companies monitoring is the natural exercise of insiders, namely the executive board.

Third, the concept of "kan dian" makes clear why Korea and Malaysia resist enforcing shareholder rights. Shareholders are outsiders in the company who as argued before have to be observed and monitored and not given extra rights.

Fourth, the internal feature of companies explains why family shareholders try to control company boards and avoid the appointment of independent directors. The latter are outsiders who again should not be given power but has to be controlled. Family shareholders dominate director appointments in order to prevent the rise of the outsiders.

The next factor of Confucian capitalism argued by Yao is "guanxi" meaning relationship.[55] In economics literature it is maybe the most well known factor of Confucian Capitalism and mostly Chinese economy. However as opposed to the general view that "guanxi" is always used in interactions, Yao argues that it is rather just one form of interaction that developed in order to manage social benefit and individualistic gains of a transaction the same time. Yao states that "guanxi" is not always used but strategically implemented in such situations when the sensitive balancing between the altruism and private benefits are specifically needed. That is also the weakness of "guanxi". As it tries to manage two contradictory notions the same time, it fails rather easily. Consequently, even Chinese have mixed feelings towards the implementation of "guanxi" and in case using this method they exercise the "art of guanxi". The latter means that certain formalities have to be in place so that "guanxi" can end with success and it does not end up with only fulfilling one side: either collective or individual interest. This is a bad outcome because the use of this form of

[55] Yao (2002) p. 12

transaction and interaction is exactly to fulfil the interests of both the individual and the group the same time.

"Guanxi" does not have implicit effects on corporate governance but establishes the way that the earlier described merger of private and business sphere can be managed. In Western societies such fusion is not possible as the people do not have the means to enforce their economic interests while they actually do not depart from assessing collective advantages. "Guanxi" provides an ambivalent tool for that which can only be successful in case of perfect implementation. However, it though means that individuals do have a method to balance the two contradictory factors.

The last factor argued by Yao is "xingyong" meaning trust.[56] "Xingyong" means personal economic relation without contract that is aiming to maximize the long term gains of cooperation.[57] In practice it is implemented when the owner of the Chinese shop makes credit possible for their customers. In order that this arrangement can work mutual trust has to in place between the two parties. Moreover, the shops also have to coordinate the conditions among each other because if they provide different possibilities than the customers will not stay a one shop but are going to move further to find the best option. Thus, there are three directions where trust is inevitable for the functioning of the "xingyong": trust to the customer in the owner of the shop and back and trust between the owners of different shops. However, trust does not mean that they believe in each other blind. As Yao argues trust is a "matter of degree"[58], meaning that it lies between the two extremes of faith and distrust. It also implies that the individual has freedom of behaviour in case of "xingyong" as they have the right to demand that the partner shows good faith before they believe his or her trustworthiness. It provides the freedom of decision whether one want to enter into a "xingyong" or not. It is

[56] Yao (2002) p. 12
[57] Yao (2002) p. 121
[58] Yao (2002) p. 122

important to emphasise that “xingyong” is used if the outcome of an exchange relationship is uncertain. Otherwise there is no need of establishing these trust relations.

“Xingyong” also explains the reluctance of Korean and Malaysian companies towards establishing audit committees. The custom of personalized non-contractual relations based on trust does not require monitoring hence the point of the relationship is that it can function simply on the basis of the trust of the partners. Moreover, external monitoring would be an aggressive interference into the “xingyong” by an outsider which would break the tie and make the relationship and through that transaction impossible.

As I argued before Confucian companies work on the basis of cooperation. The result is the company conglomerates present in both Korea and Malaysia. By these conglomerates companies internalize factors that would perhaps prevent cooperation between them. However, by internalizing them they become possible to overcome. “Xingyong” is a tool to make cooperation possible also among companies. It makes an intercompany environment that is much less competitive than the Western economies and more cooperation among the companies is present. This can be enhanced by electing semi-independent directors, who in practice are connected to another related firm because for example they were one of its former executives. By appointing directors who are in practice not independent, trust can be strengthened between companies thus “xingyong” can function better. This also causes the resistance of Korean and Malaysian company boards to appointing independent directors.

After showing that the most important features of Confucian Capitalism can explain “mock” compliance with corporate governance standards in Korea and Malaysia, the question remains, why is there though difference between the level of compliance of these two countries. Possibly it is the effect of the alternative methods present in Malaysian economic structure such as the market-based financial system and the common law tradition. These push Confucian features of Malaysian Capitalism in the background and decrease their effect.

Even more due to the fact that government took explicit measures in order to push Chinese business in Malaysia down.

4.2.3 Banking supervision and Confucian Capitalism

Both countries showed "mock" compliance with banking supervision standards as well. However, this case Korea reached high level, while Malaysia only middle.[59]

In case of banking supervision the influence of the features of Confucian Capitalism are smaller because the banking sector is more affected by globalization whereas corporate governance is rather embedded in the society. Cook argues that globalization shapes the banking sector of Korea and Malaysia as a consequence of several issues.[60] First, through the crisis that hit the region in 1997. It was the consequence of insufficient financial system so the result was that governments wanted to take measures that insure that it cannot happen again. The best way for that seemed to be to connect the national banking systems of these countries in the international banking life as the more diversified can be the portfolios of the banks the more secure is their liquidity and solvency. Second, Cook discusses that negotiations and international cooperation also enhanced globalization to have effect on these countries. Korea and Malaysia realised among others countries that in order to sustain their economic development they have to take part in trade agreements. These agreements enhance external trade which is inevitable for these countries as their growth is mostly driven by exports. However, international trade agreements require that the partners converge standards in banking sector as the effective functioning of banks and the match of banking transactions between the partners' financial systems is crucial for trade relations. Third, globalization was also brought in the economies of Korea and Malaysia through the increased foreign ownership in banking sector.

[59] Walter (2008) p. 169

[60] Cook p. 6 – 30

However, there are some features of Confucian Capitalism that can be related to the compliance outcomes of Korea and Malaysia. First, the existence or even more the opportunity for alternative financing through “Xingyong” – similar to what is present in case of the small Chinese shops – gives different point of view for Korean and Malaysian banks. Monitoring, ownership and credit ceilings are important in Western countries in order to make the system transparent and reduce the possibility of failure. However, in Confucian financial system there is tradition of lending on the basis of trust. Hence, Korean and Malaysian banks and corporate actors might not find these measures inevitable.

Second, the overall appreciation of internalisation of business life, and the existence of trust through “Xingyong” can allow banks to handle loan classification looser. As the directors feel as part of the company for them it is and overall in the society it is more important that businesses can boom than that loans are classified strictly. Moreover, as trust through “Xingyong” make financial, corporate and political actors more secure that the companies are going to pay back their credit. The same can be argued for capital adequacy and provisioning as they both are more secured through trust.

Similarly to the resistance of independence of company boards the cooperation of business and financial life makes the actors more reluctant towards the independence of financial regulators.

The difference between the outcomes of compliance between the two countries again needs explanation. Malaysia’s financial system was more market based, hence banking system was less important. Moreover, the regulators of Malaysia were aiming to conduct indigenous reform of the financial system possibly without involving foreign actors. Hence the compliance level of Malaysia remained smaller.

4.3 Conclusion

In this chapter I presented evidence that the outcome of compliance with international standards in Malaysia and South Korea matches the specific features of their variety of capitalism namely Confucian Capitalism. Hence the economic growth of the two countries do not need to be low on the basis of the VoC approach because both corporate governance and banking supervision effectively fulfils its role in the economic system.

Conclusion

Political economy theory implies that for sustainable economic growth a country has to have sound financial and corporate governance system. The former is important because it is responsible for the accumulation of savings and transferring them into investment. Modern economies cannot be financed without these financial intermediaries because individual savers do not have sufficient assets for financing a company. Moreover, financial intermediaries decrease transaction and information costs. Thus they enhance that resources are allocated to such companies that can use them most efficient. Through that they improve capital accumulation and technological development, hence drive economic growth. Corporate governance standards are important as they determine the behaviour of companies hence economic performance and economic growth. Moreover, for sustainable economic development the financial and corporate governance structure of the economy haves to mach otherwise they cannot function efficiently.

After the 199 7 crisis the IMF in line with these theoretical findings promoted the adoption of international banking, corporate governance and auditing standards in East Asia. The argumentation was that these standards represent the best practices developed in advanced economies. Hence, their implementation can make financial structure effective in these countries so that their sustainable growth is secured. The IMF also argued that the standards would help these countries overcome the structural problems that lied behind the financial crisis. Moreover, the IMF claimed that the crisis was only partly caused by the problems of financial sector and the discretionary state intervention deepened the problems. Hence, with the creation of a strong regulatory framework providing enforceable good practice the behaviour of the state can also be changed so that it stayed in the background. In professional circles the approach of the IMF was questioned, for example Krugman argued that actually that state should play bigger role in the economies in order that they can recover.

However, most of the countries decided that they implemented the IMF guidelines. Economists for a long time were writing about the high level of compliance among these countries with the standards. Thus they claimed that the IMF policy was successful. However, recent researches show that the countries comply only partly with the standards. Most of them was formally implemented, however their enforcement remained limited. This phenomenon is called “mock” compliance by Andrew Walter. He argues that even though East Asian countries comply with the standards to diverse extent they all remain on the level of “mock” compliance. On the basis of the political economic theories this implies that these countries have to follow a depressed path of economic growth.

I investigated the cases of South Korea and Malaysia. These two countries were hit the most by the crisis. South Korea did accept the support of the IMF and followed its guidelines, however, Malaysia decided oppositely. Although Malaysia did not cooperate with the IMF it also followed orthodox economic policy and ended up with implementing the standards. On the basis of the research of Walter I showed that both countries followed of “mock” compliance. However, their economic growth data do not show bad development path. Both countries grow bit faster than the average of countries on same development level which contradicts theoretical implications.

I argued that this contradiction can be explained, if the special characteristics of the structure of these two capitalisms are taken into account. Both Malaysia and Korea have long tradition of Confucianism. As Confucianism deals with the good practices in politics, economics and society, it has determined the development of capitalism in these countries. Hence the Confucian Capitalism model of Yao Souchou can be applied. The most important elements of this variety of capitalism are “kan dian”, “guanxi” and “xingyong”. “Kan dian” means that the owner of the shop looks after its workers. In Confucian business practice the structure of family is rebuilt, employees are treated as family members. However, “kan dian” also means that the owner of the shop observes the outside workers, those not belonging to the family. “Guanxi” refers to a form of transaction through that individuals try to balance private and collective interests. “Xingyong” is a personalistic, non-contractual form of cooperation in that trust between the partners is inevitable.

I argue that these characteristics match with the adopted and implemented standards of the Malaysia and South Korea. Hence, “mock” compliance is not inefficient but is a result of the speciality of these economies. “Kan dian” explain why the business societies of these countries try to avoid to give too much power to shareholders. They see them as outsiders who have to be monitored by the insiders. Hence, board independents, audit committees and shareholder rights remain limited. The alternative way of transaction of “guanxi” gives tool for the effective functioning of insider transactions thus outsider monitoring seems less important for these societies. Finally, the trust developed through “xingyong” that is embedded in these societies not only decreases further the importance of auditing but also provides means for alternative financial practices. Thus limited compliance with banking rules does not make the economy ineffective.

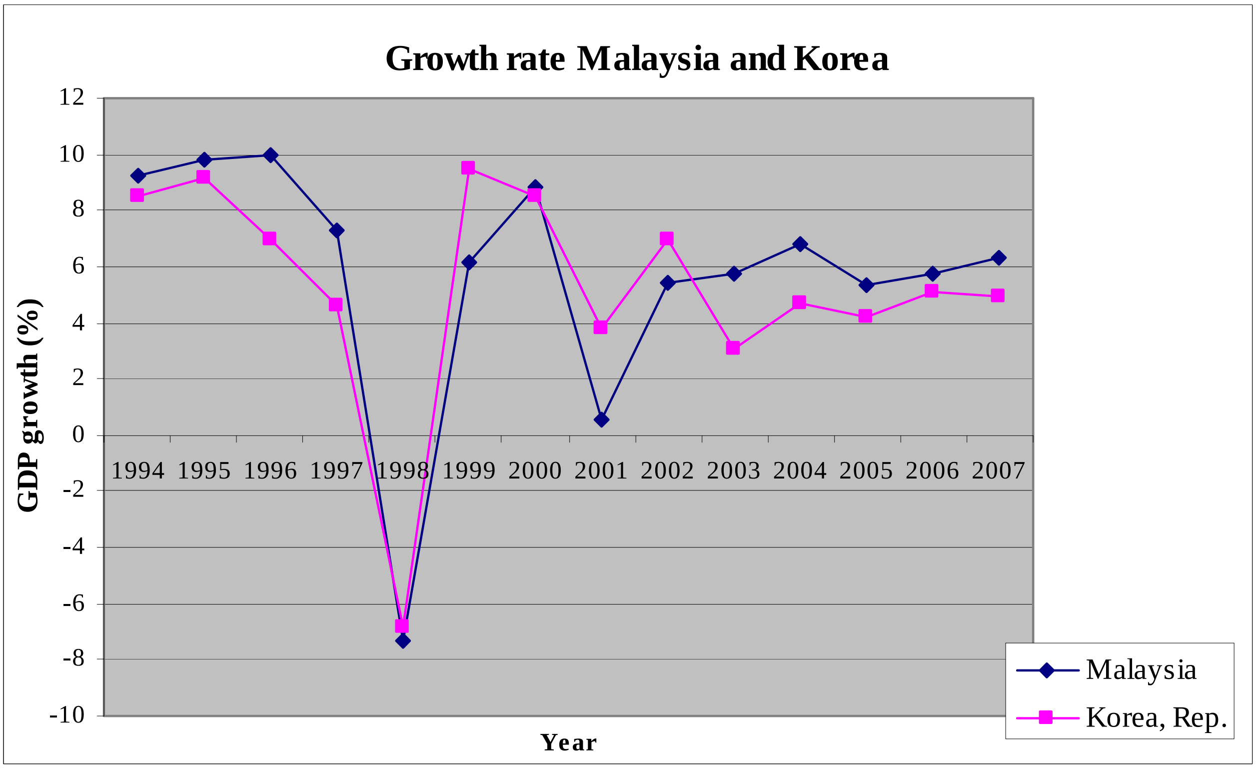
All in all the special characteristics of Confucian Capitalism explain that even though Malaysia and South Korea implemented only “mock” compliance with international standards their economic growth remained above average. My analysis did not examine the reasons lying behind the difference in the growth rate of the two countries because it falls out of the possible scope of this thesis. However, future research should address this phenomenon. One of the possible explanations is that in Korea banking system and corporate governance structure does not match each other which cause problems in the economic development. Korea reached high level of compliance with banking standards but only low level with corporate governance standards. However, Malaysia reached middle level with both set of standards. This can imply there is mismatch in case of Korea but not in case of Malaysia.

Nevertheless, future research has to investigate the legitimacy and possible proof of this explanation.

Appendix 1: Figures

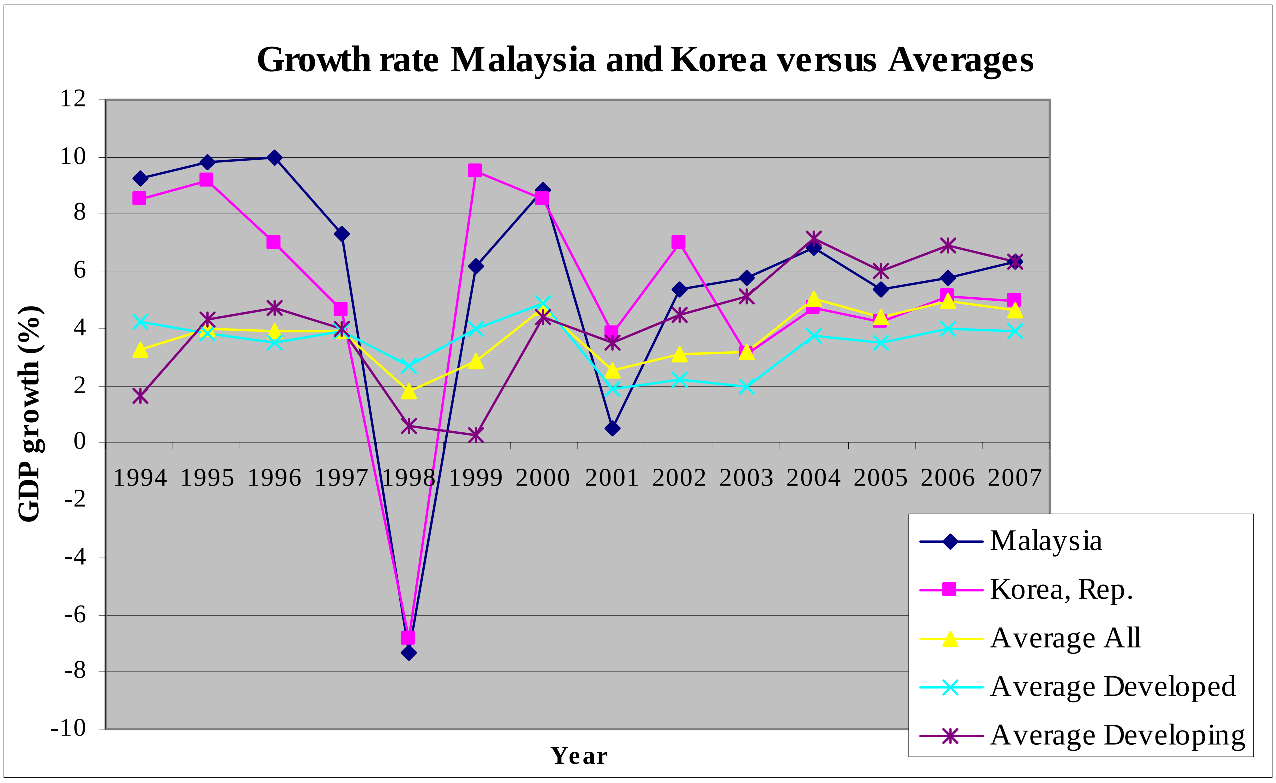
Appendix 1.1 Malaysia and Korea

Graph 1: GDP growth (%) for Malaysia and Korea from 1994 to 2008.



Appendix 1.2 Malaysia and Korea versus averages

Graph 2: GDP growth (%) for Malaysia and Korea versus three averages from 1994 to 2008.



<u>Average Developed contains:</u> *Australia, Austria, Belgium, Canada, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Greece, Hong Kong, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Malta, Netherlands, New Zealand, Norway, Portugal, Singapore, Slovak Republic, Spain, Sweden, Switzerland, United Kingdom and United States of America.*[61]

<u>Average Developing contains:</u> *Belarus, Bulgaria, Croatia, Fiji, Indonesia, Kazakhstan, Latvia, Lithuania, Mongolia, Montenegro, Palau, Malaysia, Philippines, Poland, Romania, Serbia, Thailand and Turkey.*[62]

Average All is a combination of Average Developed and Average Developing.

[61] IMF (2009) p. 184

[62] IMF (2009) p. 184 and World Bank Quick Query (2009)

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